DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 03-0216
Indiana Corporate Income Tax
For 1999, 2000, and 2001

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ISSUES

I. Rent Expense Computational Error.

Authority: IC 6-8.1-5-1(b).

Taxpayer argues that the audit erred by understating the amount of its rent expenses.

II. Royalty Income Received from the Licensing Trademarks to Foreign Subsidiaries – Adjusted Gross Income Tax.

Authority: IC 6-3-1-20; IC 6-3-2-2(a); IC 6-3-2-2(a)(5); IC 6-3-2-2(b); IC 6-3-2-2(g) to (k); IC 6-3-2-2.2; Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983); May Department Store Co. v. Indiana Dept. of State Revenue, 746 N.E.2d 651 (Ind. Tax Ct. 2001); Chief Industries v. Dep't of Revenue, 792 N.E.2d 972 (Ind. Tax Ct. 2000); Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999); 45 IAC 3.1-1-29; 45 IAC 3.1-1-30.

Taxpayer claims that the audit incorrectly classified its royalty income as "business" income and that the income should be classified as "non-business."

STATEMENT OF FACTS

Taxpayer is an out-of-state air carrier in the business of transporting and delivering packages. Taxpayer operates both within and without the United States.

The Department of Revenue (Department) conducted an audit review of taxpayer's returns and business records. The audit made a number of adjustments. Taxpayer challenged two of these adjustments and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer explained the basis for the protest. This Letter of Findings results.

DISCUSSION

I. Rent Expense Computational Error.

In preparing its federal income tax return for the fiscal year ending May 31, 2001, taxpayer erroneously listed certain royalty payments as "other deductions." Before taxpayer filed the return, the error was discovered and corrected. When taxpayer's general ledger was incorporated into its tax software, the royalty payments were "mapped" to the rents expense line of its pro forma income tax return. An "adjusting entry" was made in the software program to move these royalty payments from the return's expense line to the gross royalties' income line. However, while the income portion of the adjusting entry was credited correctly, the wrong expense line was debited. This posting error resulted in an offsetting debit and credit being reported on two separate expense lines on the federal return.

In reviewing taxpayer's records, the audit made an adjustment to taxpayer's rent expense. According to taxpayer – and in apparent reliance upon the taxpayer's own records – the audit substantially understated the amount of taxpayer's rent expense.

Taxpayer now asks that this error be corrected.

The audit's original determination is presumed correct. IC 6-8.1-5-1(b) states in part that, "The notice of proposed assessment is prima facie evidence that the department's claim for unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with person against whom the proposed assessment is made."

Taxpayer has provided detailed financial records purporting to establish that the amount of rent expense as indicated on the audit report was erroneous and attempting to explain the basis for that error.

A letter of findings is not the appropriate means by which to correct mathematical or accounting errors. However, taxpayer has met its burden of demonstrating that its argument is neither wholly unsubstantiated nor entirely frivolous. The audit review is requested to review the original audit report, taxpayer's newly provided information, taxpayer's narrative, and to make whatever adjustment may be appropriate.

FINDING

Subject to audit's review, taxpayer's protest is sustained.

II. Royalty Income Received from the Licensing Trademarks to Foreign Subsidiaries – Adjusted Gross Income Tax.

Taxpayer has foreign subsidiaries. The subsidiaries are also in the business of transporting and delivering packages. Taxpayer entered into agreements which permit these subsidiaries to use taxpayer's trademarks. These agreements are called "Service Mark Agreements." In return for the right to use these trademarks, the foreign subsidiaries pay taxpayer royalties.

The taxpayer originally classified this income as "non-business income" and reported it on Schedule F of taxpayer's Indiana corporate income tax returns. During the audit review, the

income was reclassified from "non-business income" to "business income." The audit did so citing as authority 45 IAC 3.1-1-29. In part, that regulation reads as follows:

> "Business Income" defined. "Business Income" is defined in the Act as income from transactions and activity in the regular course of the taxpayer's trade or business including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer's regular trade or business.
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> Nonbusiness income means all income other than business income.
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> The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, non-operating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business.

Whether taxpayer's income is classified as "business" or "non-business" makes a difference because of the way in which a corporate taxpayer's adjusted gross income is calculated. For purpose of determining a taxpayer's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three-factor formula. IC 6-3-2-2(b). In contrast, non-business income is either allocated to Indiana or is allocated to another state. IC 6-3-2-2(g) to (k). Therefore, "whether income is deemed business income or non-business income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states [in which] the taxpayer is conducting its trade or business." May Department Store Co. v. Indiana Dept. of State Revenue, 746 N.E.2d 651, 656 (Ind. Tax Ct. 2001).

If – as taxpayer contends – these royalty payments constitute "non-business" income, then the income is allocated outside of Indiana. In addition, taxpayer raises alternative threshold issues.

A. Royalty Income as Derived From Sources Within Indiana.

Taxpayer states the royalty payments are not taxable under Indiana law because the royalty payments are not "derived from sources within Indiana." Taxpayer contends that it is not necessary to reach the "business" / "non-business" distinction because the income should be "sourced" to the out-of-state location where the royalty income was generated. In support of that argument, taxpayer cites to Chief Industries v. Dep't of Revenue, 792 N.E.2d 972 (Ind. Tax Ct. 2000).

Taxpayer seeks to turn the adjusted gross income tax scheme on its head by setting out a threshold sourcing test. It is difficult to accept taxpayer's argument in the face of the generally accepted statutory scheme under IC 6-3-2-2(a) to (k). The scheme asks whether the royalties are business or non-business income and whether the sales, payroll, and property of the taxpayer are apportionable to Indiana in the case of business income or the income is allocable to Indiana in the case of non-business income.

"[S]tates do not have to evaluate each income generating activity of the corporate enterprise in order to determine whether the income gained from that activity is properly taxable by the state. Instead the state may look at all of the income gained by the corporate enterprise's business activity and determine the state's fair share of that total." Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766, 769 (Ind. Tax Ct. 1999). Taxpayer's effort to interpose a threshold sourcing test for royalty income does not survive close scrutiny. "In order to determine what income is attributable to Indiana, it must *first* be determined whether the income sought to be attributed is business or non-business income." Id. at 771 (*Emphasis added*).

Taxpayer's argument that out-of-state royalty income – by definition – falls outside Indiana's adjusted gross income tax scheme is not well founded. The Indiana legislature has defined "adjusted gross income" as including "(1) income from real or tangible personal property in this state; (2) income from doing business in this state; (3) income from a trade or profession conducted in this state; (4) compensation for labor or services rendered within this state; and (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter." IC 6-3-2-2(a). IC 6-3-2-2(a)(5) includes an internal reference to IC 6-3-2-2.2 but IC 6-3-2-2.2 is limited in its effect acting only to describe the manner in which interest and dividend is attributed to the state.

B. Royalties as Business / Non-business Income.

The audit found that the royalty income received from taxpayer's foreign subsidiaries constituted "business" income. Taxpayer disagrees arguing that it is in the package transportation business and not in the business of licensing intangibles.

The benchmark for determining whether income can be apportioned is the distinction between "business income" and "non-business income." That distinction is defined by the Indiana Code as follows:

> The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operation. IC 6-3-1-20.

"Non-business income," in turn, "means all income other than business income." IC 6-3-1-21. For purposes of calculating an Indiana corporation's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three-factor formula, while non-business income is allocated to Indiana or another state in which the taxpayer is doing business. May, 749 N.E.2d at 656. In that decision, the Tax Court determined that IC 6-3-1-20 incorporates two tests for determining whether the income is business or non-business: a transactional test and a functional test. Id. at 662-63. Under the transactional test, gains are classified as business income when they are derived from a transaction in which the taxpayer regularly engages. The particular transaction from which the income derives is measured against

the frequency and regularity of similar transactions and practices of the taxpayer's business. Id. at 658-59.

Under the functional test, the gain arising from the sale of an asset will be classified as business income if the acquisition, management, and disposition of the property generating income constitutes an integral part of the taxpayer's regular trade or business operations. *See* IC 6-3-1-20.

Department regulations 45 IAC 3.1-1-29 and 45 IAC 3.1-1-30 provide guidance in determining whether income is business or non-business under the transactional test. 45 IAC 3.1-1-29 states in relevant part that, "Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is 'business income' or 'non-business income' is the identification of the transactions and activity which are the elements of a particular trade or business." 45 IAC 3.1-1-30 provides that, "[f]or purposes of determining whether income is derived from an activity which is in the regular course of the taxpayer's trade or business, the expression 'trade or business' is not limited to the taxpayer's corporate charter purpose of its principal business activity. A taxpayer may be in more than one trade or business, and derive business therefrom depending upon but not limited to some or all of the following:

(1) The nature of the taxpayer's trade or business.

(2) The substantiality of the income derived from the activities and the percentage that income is of the taxpayer's total income for a given tax period.

(3) The frequency, number of continuity of the activities and transactions involved.

(4) The length of time the property producing income was owned by the taxpayer.

(5) The taxpayer's purpose in acquiring and holding the property producing income.

The functional test focuses on the property being disposed of by the taxpayer. Id. Specifically, the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. May, 749 N.E.2d at 664. In order to satisfy the functional test, the property generating income must have been acquired, managed, and disposed by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. In May, the Tax Court defined "integral" as "part of or [a] constituent component necessary or integral to complete the whole." Id. at 664-65. The court concluded that petitioner retailer's sale of one of its retailing divisions was not "necessary or essential" to the petitioner's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not the petitioner. Id. at 665. In effect, the court determined that because the petitioner was forced to sell the division in order to reduce its competitive advantage, the sale was not integral to the petitioner's own business operations. Id. Therefore, the proceeds from the division's sale were not business income under the functional test. Id.

The audit correctly decided that the money received in the form of royalty payments constituted "business income." Taxpayer's core business involves the transportation and delivery of packages; however, taxpayer has also entered into agreements whereby it licenses its trademarks – developed during and associated with the package delivery and transport business – to its foreign subsidiaries. These agreements are ongoing arrangements by which taxpayer receives royalty payments acknowledging taxpayer's primary ownership of the trademarks, acknowledging the value of the trademarks to the foreign subsidiaries' business, and acknowledging the value of the trademarks developed through taxpayer's business acumen, experience, and reputation. The royalty proceeds are properly classified as "business income" pursuant to the transactional test.

In addition, the income is properly classified as "business income" under the functional test because the trademark properties are an integral part of taxpayer's package transportation and delivery business. Although taxpayer may be correct in stating that it is not in the business of licensing trademarks, that distinction is irrelevant. The issue is not whether taxpayer is or is not in the business of licensing trademarks. The issue is whether the royalties are classified as "business" or non-business" income. During the regular course of its business, taxpayer decided to license its valuable trademarks to its subsidiaries, to exploit the value of the trademarks it had nurtured, and thereafter to allow – in return for valuable consideration – its own subsidiaries to employ those trademarks in developing and promoting the subsidiaries' package transportation and delivery business. The royalty income is properly classified as "business income" pursuant to the functional test.

C. Royalty Expense Deductions.

Taxpayer argues that if the Department classifies the royalties as "business income," it is being inconsistent because – in addressing issues related to royalty payments – the Department "has repeatedly held that the licensee should not be entitled to a deduction for [royalty] payments, holding in essence that the payments should be disregarded for Indiana adjusted gross income tax purposes." Taxpayer refers to instances in which a trademark licensee has been refused permission to claim, as legitimate business expenses, royalty payments made to a licensor with which the licensee has a symbiotic business relationship. Taxpayer refers to instances in which a claimed business expense has been disallowed because the royalty payments were based upon a sham transaction without any rational or justifiable business purpose. Taxpayer cites to instances in which the claimed business expenses were disallowed because the royalty payments were simply a charade to avoid state income tax liability. Nonetheless, taxpayer argues that because – in certain instances – the Department has disallowed royalty business expenses, the Department cannot now classify royalty receipts as "business income."

Taxpayer is mixing apples and oranges. Taxpayer is correct in pointing out that the Department has disallowed claimed business expenses because the royalty payments upon which the expenses were claimed were simply an elaborate accounting ruse. However, the allowance or disallowance of business expenses is an issue entirely separate from the issue of whether royalty income is or is not "business income."

D. Constitutionality.

Taxpayer argues that "any attempt to impose tax would in fact violate the Commerce Clause and Due Process Clause of the United States Constitution." Taxpayer cites to Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983) in support of its argument that because "All aspects of the licensing transactions occurred outside Indiana . . . [a]ny efforts to impose tax under these facts would violate the constitutional prerequisites for apportionment of income." Taxpayer somewhat overstates the constitutional constraints imposed on Indiana. The Constitution does indeed restrict an individual state's right to "tax value earned outside its borders." Id. at 164. However, Indiana does not seek to levy an income tax on taxpayer's royalty payments; Indiana seeks to tax taxpayer's unitary business – which necessarily includes the royalty payments – based upon well-founded, long-established, apportionment principles which observe the distinction between "business" and "non-business" income. "[I]t is constitutionally permissible for a State to tax an apportioned share of a corporate enterprise's multi-state income." Hunt, 709 N.E.2d at 769. Having determined that the royalty income should be included within the formulary tax calculation, taxpayer then "has the burden of showing by clear and cogent evidence that the state tax results in extraterritorial values being taxed." Container Corp. at 164. (Punctuation omitted). Taxpayer has failed to do so, and the Department is unable to agree that apportionment of taxpayer's royalty income is constitutionally offensive.

FINDING

Taxpayer's protest is respectfully denied.

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